December 2024

Ninety One

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Investing for a world of change

Global Balanced: a global approach to meeting local investors' needs

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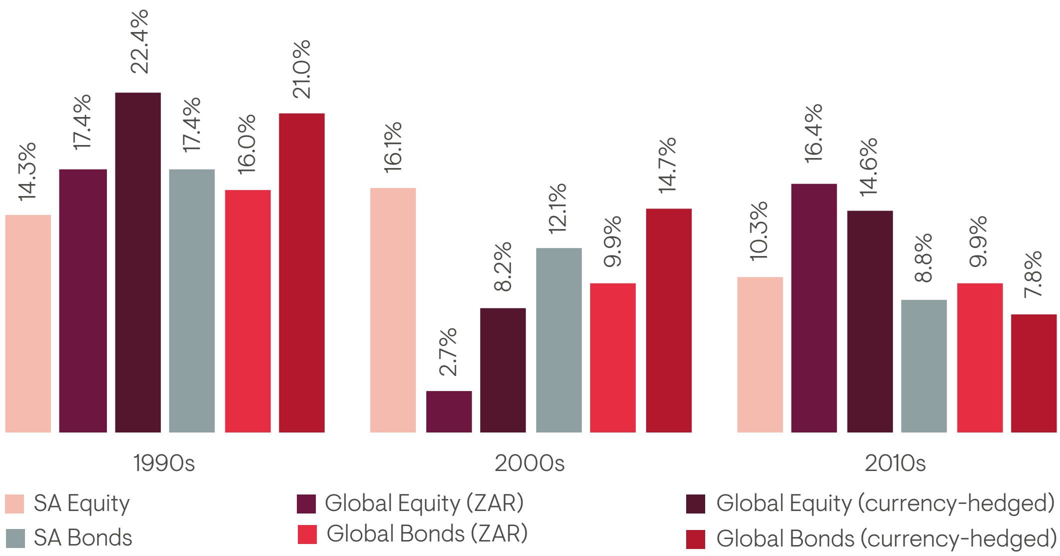
Ninety One's SA Equity and Multi-Asset team manages versatile strategies that invest across stocks, bonds and credit in both emerging and developed markets. Despite the inherent complexity of this approach, Ninety One's integrated process sets us apart.

The South African investment industry has seen significant shifts take place in recent years, both in response to global developments and due to local factors. One of the most consequential local developments has been the adjustment of Regulation 28 of the Pension Funds Act to permit up to 45% of assets of retirement funds to be invested offshore. In addition, this increase has come **after** a ten-year period where global equities, mainly US equities, have re-rated strongly while our local asset classes have de-rated delivering mediocre returns at best. What do these changes imply from an asset allocation perspective for long-term investors?

On the one hand, you could argue that due to the increased opportunity set and enhanced diversification benefits, assets should always be invested at the maximum offshore level. This argument can be further supported by relative market return data of the last decade. However, one should be careful not to extrapolate recent historic trends as your primary argument for the future. Market trends change which is evident when comparing the returns from the primary asset classes over the last three decades.

Figure 1: Comparing returns from the primary asset classes over the last three decades

Over the last 20 years: SA Equities from 'hero to zero'; global equities from 'dog to diamond'



Source: Ninety One, Bloomberg; All returns are in ZAR, annualised.

Just over the last six months for example, sentiment towards the outlook for South African asset classes has shifted dramatically for the better. At the start of this year, expectations were engulfed by loadshedding, collapsing infrastructure, brewing election uncertainty, high inflation and interest rates coupled with weak economic growth prospects. Yet today, while there are still numerous problems to be solved, sentiment has been shifting for the better, positively impacting return prospects for local asset classes. In our Balanced with International strategies, we have actively reduced the offshore allocation from over 40% earlier in the year to current levels around the mid-thirties. And within our local allocation, exposure has been increased to those equity market sectors which are mostly geared to an upswing in local consumer sentiment and an improvement in domestic growth optimism. This has largely been done through cutting the exposure to global developed market bonds, after the rally before interest rate cuts.

While we are more optimistic on our outlook on domestic assets and have adjusted our clients' portfolios accordingly, we have no certainty on the sustainability of this relative trend over the longer term. While thorough research underscores our current view and high conviction positioning, market and economic conditions change. When this happens, we will adjust the portfolio accordingly. With a higher offshore allowable allocation comes more flexibility, but also more responsibility to try to add additional returns when opportunities present themselves.

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Navigating global asset classes is however a complex task, with valuations and fundamentals varying widely across regions and sectors. Deciding where to invest our clients' hard-earned savings requires careful consideration and expertise. Though Ninety One is rooted in an emerging market, we are a global company focused on world markets, enabling us to seize opportunities wherever they arise. But, with a universe of thousands of stocks to choose from and global fixed-income markets, investors may wonder how we decide which ones to hold – and which to let go.

A truly global integrated investment approach

The question was simpler when pension funds were limited to a 30% offshore allocation, which was typically directed toward large-cap equities in developed markets. However, the increase in the regulatory cap to 45% in 2022 significantly broadened the scope, introducing greater complexity and a wider range of opportunities to consider.

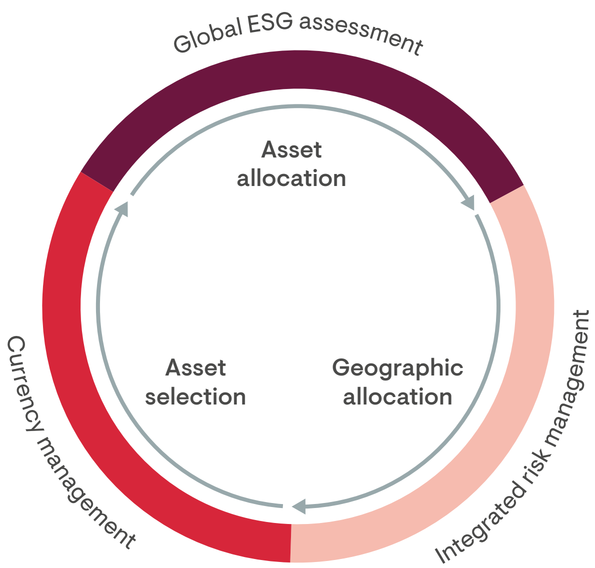
As a starting point, and by virtue of Ninety One's global focus, the SA equity and Multi Asset team utilises a strategic asset allocation model based on historical data to determine the optimal mix of assets. The model suggests a neutral allocation of 65% to equities (35% local, 30% global) and 35% to fixed income (27% local, 8% global), with global fixed income hedged into rands to mitigate currency risk.

Over the long term, we believe the increased offshore allocation opportunity should support and enhance the return profile of South African pension fund investors. However, if not correctly managed, investing offshore may broaden the investment opportunity set, but could pose an additional risk to local savers. Based on our experience, we concluded several years ago that an allocation to offshore assets using stand-alone strategies or third-party managers was suboptimal. In response, we developed our holistic approach, considering our offshore investments on a total integrated portfolio basis. This approach has two key distinguishing features which we believe is crucial for investors:

1. This implies full decision-making of all assets and control over them
2. 'Offshore is not just an add-on' – both local and offshore assets are managed with our SA client's investment objectives in mind

A truly global integrated investment approach relates to investment decision making across all geographies and asset classes and even at the individual stock selection level. This is necessary to enable appropriate ongoing risk and exposure management and currency management. Our firmwide emphasis on ESG enables us to apply principles of sustainability and ESG considerations to the full scope of our client's local and offshore assets.

Providing an integrated multi-asset solution for South African investors



Source: Ninety One.

Our integrated investment approach is complimented by Ninety One's proprietary *Compelling Forces Framework*, a scoring methodology for evaluating all investment opportunities across three key metrics:

- **Fundamentals** (What are the underlying growth, inflation and policy dynamics? Do the facts underlying the investment support its case?),
- **Valuation** (is the investment cheap, expensive or fairly valued?), and
- **Market price behaviour** (considering market positioning and sentiment dynamics).

The magic lies in identifying where we are in the economic cycle and allocating capital accordingly, ensuring the right balance across growth, inflation, and policy considerations from a top down perspective while identifying bottom-up opportunities to enhance potential risk-adjusted returns.

How do we do this as a team?

A wide array of variables come into play, which is why we rely on our global research platform, which integrates the expertise of portfolio managers and analysts across various asset classes. This includes consideration of the potential impacts of ESG/sustainability dynamics.

Within this framework, equity selection involves researching and debating stock ideas to ensure sound decision-making. Approved companies are added to a buy list from which we select ideas with a consideration for what we hold in South Africa given the regulatory requirement to invest a minimum of 55% locally.

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When evaluating a sector – take the paper sector for instance - our local analysts compare and rank SA-based companies, such as Sappi and Mondi, against global listed peers such as UPM or Smurfit Westrock. Similarly, in the tobacco sector, our analysts benchmark locally listed companies like British American Tobacco against global giants such as Japan Tobacco and Philip Morris International. This dual perspective allows us to assess local opportunities in a global context. Similarly, leveraging our local and global Fixed Income teams' research, our local bonds and credit opportunities are evaluated relative to other emerging and developed market opportunities.

Although our portfolios incorporate various asset classes, equities form the bulk, typically from 60-75%. To further simplify our process, we categorise the companies we invest in into three categories: growth, defensive and cyclical. This approach helps balance the portfolio and manage exposure to different economic cycles.

As described above, we scrutinise each local opportunity individually, leveraging our fundamental research team of analysts and using a stock screening tool to enhance debate and discussion. Internationally, we utilise a quantitative screening tool to filter a vast universe of stocks into a refined list, which is then subjected to the same rigorous evaluation process.

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South Africa's market is heavily skewed towards cyclical companies, so being able to invest offshore provides a valuable counterbalance. By going global, we shield the portfolio from the cyclical nature of local companies and gain access to a wider spectrum of growth and defensive opportunities.

Ultimately, regardless of the category, our stock selection is anchored in an earnings-focused approach, as we believe earnings ultimately drive share prices. The South African market offers an additional advantage: frequent earnings revisions, which can present further investment opportunities. Our analysts formulate their view around each company's earnings expectations and valuation reasonability. These forecasts are then compared with market expectations, both locally and globally, to inform our investment decisions.

Integrated risk management is a crucial aspect of our strategy. Our portfolio undergoes stress testing to ensure robustness and management of risks, including identifying potential unintended consequences from bottom-up asset selection that embeds an unintended macro view for the overall portfolio. This process includes macro stress tests of the overall portfolio and analysis of subcomponents like equities and bonds. We also consider the portfolio's overall see-through currency exposure. For example, when we allocated a much larger portion of the fund offshore (due to the bottom-up selection opportunities being stronger than the local opportunities), we employed a rand hedge to a portion of the portfolio. Our analysis suggested an oversold currency, albeit with weaker local asset selection opportunities. However, when the local opportunities offered a more compelling opportunity and we allocated more capital domestically, we removed the rand hedge.

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Our approach, informed by comprehensive research and analysis that integrates both top-down and bottom-up considerations, ensures we navigate changing market conditions effectively. While capital has been repatriated to SA and the mix of SA-focused companies in our equity selection has increased, our positions remain aligned with the consistent application of our robust process framework. This enables us to capitalise on market volatility over time, delivering inflation-beating, risk-adjusted returns for our clients.

We believe our well-resourced globally integrated investment team, robust, repeatable process and holistic approach to portfolio construction will help investors meet their investment objectives.

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CS_736 12/2024